Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:POSTF-163077-01
HNAdams

date: December 7, 2001

to: Large & Mid Size Business Division
Territory Manager (Heavy Manufacturing, Construction & Transportation)
Attn: Ronald Whitford, Group 1656

from: Associate Area Counsel (Financial Services)
CC:LM:FS:LI

subject: [redacted] - **Section 704(b) Disclosure Issue**

U.I.L. No. 6103.00-00

This memorandum responds to your request for assistance of November 7, 2001. This memorandum should not be cited as precedent.

FACTS

For purposes of this response, we understand the facts are as follows.[1] [redacted] ([redacted]) is a limited partnership that was formed in [redacted]. [redacted] filed partnership returns for each of the years [redacted], [redacted], [redacted], and [redacted]. [redacted] had three partners during each of those years: general partner [redacted] and limited partner [redacted] (both subsidiaries of [redacted] and members of the [redacted] consolidated return group), and limited partner [redacted] (a member of the [redacted] consolidated return group).

The Service is examining [redacted]'s [redacted], [redacted], [redacted], [redacted], and [redacted] years. The examination relates to whether income that was allocated to [redacted] is properly reportable by one or both of the [redacted]-affiliated partners. One of the issues is whether the partnership allocations have substantial economic effect within the meaning of Treasury regulation section 1.704-1(b)(2)(iii)(a). Section 1.704-1(b)(2)(iii)(a) provides that the economic effect of an allocation is substantial if there is a

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[1] Our understanding of the facts is based on information we have received from you.

reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Section 1.704-1(b)(2)(iii)(a) further provides that the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement:

(1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and

(2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

The examination team determined that the [redacted] partnership allocations enhanced the after-tax economic consequences of all of the partners. It determined based on information obtained by the Service in connection with the examination of the [redacted] consolidated return that the allocations to the two partners that were members of the [redacted] consolidated return group enhanced the after-tax economic consequences for the group, and from information obtained by the Service in connection with the examination of the [redacted] consolidated return that the allocation to [redacted] enhanced the after-tax economic consequences of the [redacted] consolidated return group. It obtained the information regarding the [redacted] consolidated return group from the examination team assigned to the [redacted] consolidated group. It had the information regarding the [redacted] consolidated return group because it was assigned to examine that group.

ISSUE

May the examination team disclose in the RAR issued in connection with the [redacted] examination return information of the [redacted] and [redacted] consolidated return groups?

CONCLUSION

The examination team may disclose in the RAR issued in connection with the [redacted] examination return information of the [redacted] and [redacted] consolidated return groups to the extent it is necessary to disclose the information to demonstrate that [redacted]'s partnership allocations did not have substantial economic effect within the meaning of Treasury regulation section 1.704-1(b)(2)(iii)(a).

ANALYSIS

Code section 6103(a) prohibits Service employees from disclosing "returns" or "return information," as those terms are defined in sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. Section 6103(b)(2) defines return information to include, among other things, any data that is received by, recorded by, prepared by, furnished to, or collected by the Service with respect to a return or with respect to the determination of the existence or possible existence of liability or the amount of liability of any person under Title 26. The information that the examination team used to determine that the [redacted] partnership allocations enhanced the after-tax economic consequences of all of the partners is the return information of the [redacted] and [redacted] consolidated groups as the Service obtained it in connection with the returns of those groups or the examination of those returns.

Section 6103(h)(1) authorizes the disclosure of returns or return information to officers and employees of the Treasury Department whose official duties require such disclosure for tax administration purposes. Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes * * *." I.R.C. § 6103(b)(4). In essence, section 6103(h)(1) authorizes access to tax information when the employee establishes a "need to know" in order to perform a tax administration function. An examination of a taxpayer's return is a tax administration function.

Although section 6103(h)(1) permitted the [redacted] examination team to obtain the return information of the [redacted] and [redacted] consolidated groups, it does not authorize the [redacted] examination team to disclose the information of those other taxpayers to [redacted] in the RAR it intends to issue in connection with the [redacted] examination. [redacted] and each of its partners are separate taxpayers for purposes of Code section 6103. A partner is not entitled to disclosure of returns or return information of another partner. <u>See</u> <u>Martin v. IRS</u>, 857 F.2d 722 (10th Cir. 1988). Third party return information may only be disclosed by the Service under sections 6103(h)(4)(B) and/or (C).

Section 6103(h)(4) is a narrowly tailored exception to the confidentiality requirements of section 6103(a), which specifically lifts the confidentiality constraints and authorizes disclosure of certain tax returns and return information in judicial or administrative tax proceedings. Subparagraphs (B) and (C) of section 6103(h)(4) establish item and transaction tests, respectively, under which returns and return information of taxpayers that are not parties to such proceedings may nevertheless be disclosed. Under section 6103(h)(4)(B), a third party taxpayer's statutorily protected return information may be disclosed in judicial or administrative tax proceedings only "if the treatment of an item reflected on such [third party's] return is directly related to the resolution of an issue in the proceeding." Under section 6103(h)(4)(C), a third party taxpayer's statutorily protected information may be disclosed in judicial or administrative tax proceedings only "if such [third party's] return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the [third party] taxpayer which directly affects the resolution of an issue in the proceeding * * *."

In the circumstances presented here, the relevant inquiry is whether subsection (B) and/or (C) permits [redacted]'s examination team to disclose to [redacted], in its audit, information that was provided to the Service by the partners of [redacted] in connection with their returns or the examination of their returns. An RAR would be issued in connection with the audit of the Federal partnership returns of [redacted]. It is the Service's position that an examination is an administrative tax administration proceeding.[2] <u>First Western Government Securities, Inc. v. United States</u>, 796 F.2d 356, 360 (10th Cir. 1986), <u>aff'g</u>, 578 F. Supp. 212 (D. Colo. 1984); <u>Nevins v. United States</u>, 88-1 U.S.T.C. ¶9199 (D. Kan. 1987) (reasoning that audit is administrative proceeding for purposes of Code section 6103(h)(4)); <u>but</u> <u>see</u> <u>Mallas v. United States</u>, 993 F.2d 1111, 1121-22 (4th Cir. 1993) (reasoning that audit is not an administrative proceeding for purposes of Code section 6103(h)(4)).

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[2] The disclosure of third party tax information necessary to substantiate the Service's position in the examination facilitates early resolution of issues at the administrative level. It would truly be incongruous to require the Service to wait until the case is litigated to disclose any third party information supporting an adjustment.

The next question we must address is accordingly whether the item and/or transaction tests of section 6103(h)(4)(B) and/or (C) are met in order to allow the Service to disclose return information of the [redacted] and [redacted] consolidated return groups in an RAR to be issued to [redacted] during [redacted]'s audit. There are two statutory requirements under section 6103(h)(4)(C) that must be met in order for third party return information to be disclosed in an administrative proceeding. The first requirement is that the third party return information must relate to a transactional relationship between the taxpayer and the third party. The second requirement is that the information directly affects the resolution of an issue in the proceeding. Here, the return information of the [redacted] and [redacted] consolidated return groups meets the first part of the test. Members of those consolidated return groups are transactionally related to [redacted] because they were partners of [redacted] and received allocations from [redacted] the economic effect of which are at issue in the [redacted] examination. It would also appear that such information would directly relate to the resolution of the issue in the proceeding, i.e., whether the allocations had substantial economic effect. However, the item and transaction tests are factually nuanced, and each item of information needs to be evaluated separately to determine whether it meets the test.[3] Thus, under sections 6103(h)(4)(B) and/or (C), the return information of the [redacted] and [redacted] consolidated return groups related to whether the [redacted] partnership allocations enhanced the after-tax economic consequences of all of the partners may be disclosed by the Service in an RAR to be issued to [redacted] during [redacted]'s examination to the extent it is necessary to disclose the information to demonstrate that [redacted]'s partnership allocations did not have substantial economic effect within the meaning of Treasury regulation section 1.704-1(b)(2)(iii)(a).

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect or if additional facts are developed. If the facts are determined to be incorrect or if additional facts are developed, this opinion should not be relied upon. If we can be of further assistance, you may call the undersigned at (516) 688-1737.

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[3] While we have analyzed this under the transaction test, it is clear from the legislative history that the same principles would apply to the item test, i.e., that the information relate to some dealings or transaction between the parties. See Tavery v. United States, 32 F.3d 1423, 1430 (10th Cir. 1994), Lebaron v. United States, 794 F. Supp. 947 (C.D. Cal. 1992).

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